
- ***DEFERRED COMPENSATION PLANS REGARDING PORTFOLIO COMPANIES***

Staff received a letter from the Controller, Dr. Connell, on January 15, 2002 regarding deferred compensation plans at portfolio companies. The letter is attached and labeled Attachment 1. The Controller also requested that staff review the top 20 holdings in the equity portfolio and report on which companies follow the policies outlined in the letter. Staff has done a cursory review of the top 20 holdings. This review does not address the deferred compensation issues raised in the letter, as this information is not readily available. These reports are labeled Attachment 2.

Additional resources will be necessary if the members direct staff to complete the survey. Staff seeks direction on this issue. Following is a summary regarding deferred compensation plans for your perusal.

Background

Deferred compensation is an agreement between a company (typically) and an individual employee that defers all or a portion of their compensation which will be paid over a stipulated period of time, or upon retirement. The objective is to shift income from the current period to future years. This is an investment decision for the employee. Compensation experts define compensation as one or more of these five elements: (1) salary; (2) short-term incentives; (3) long-term incentives; (4) employee benefits; and (5) perquisites. Deferred compensation plans can either be voluntary or mandatory and can be applicable to one, some or all of the above elements. Deferred compensation plans are either funded or non-funded, qualified or non-qualified, and forfeitable or non-forfeitable. A formally funded plan is one where the benefits promised by the employer are secured by rights to property, such as stock, insurance or some other negotiable item.

Indirectly or informally funded plans are plans where the company sets up a reserve to cover the amount of the liability, but also retains sole control over its application. In the instance of financial failure in an indirectly or informally funded plan, the employee stands in line as an unsecured creditor seeking settlement of the claim. In a formally funded plan, the funding of the liability is direct and the payment will be made from the property set aside. A non-funded plan is one backed only by a promise of the employer to pay. In addition to these categorical distinctions, there are some Internal Revenue Code distinctions as well.

A qualified plan must meet a number of tests dealing with such items as: (a) permanency; (b) nondiscriminatory coverage and benefits; and (c) non-recoverability of employer contributions. The advantage of qualified plans, covered by Section 401 of the Internal Revenue Code and E.R.I.S.A., is that while the employer receives a tax deduction in the amount of the contribution to the plan, the employee's tax liability is deferred until benefits are actually received. A nonqualified plan is one not meeting the requirements of Section 401 of the Code; there is no tax deduction until the employee receives taxable income.

There are disadvantages to deferring income. Unless the amount deferred is protected against inflation, it may have significantly reduced value when received than when earned. If the deferred income is invested in stock, it may have reduced or no value when received. These are two of the main reasons that 401(k) plans that are offered to the majority of employees are voluntary and are presented as needs-investment decisions.

Companies generally have a more restrictive deferral plan for senior executives, since the plans at this level are a way to attract and retain executive talent. Such plans will often mandate that a certain portion of the executives' income be deferred and that the deferral be in some form of stock, either phantom or real. Attached to this item are cursory company reports on the top twenty holdings in the CalSTRS equity portfolio. We have not surveyed any portfolio companies on the status of their deferred compensation plans, to date. The information is not readily available and any research effort will be intense.

Discussion

The Controller's letter concentrated on the deferred compensation plan aspect of the Enron failure. The Federal Government establishes the rules that guide 401(k) plans. Companies are allowed some flexibility in the issue of matching contributions with company stock and the holding period requirement. There are significant pros and cons surrounding employee ownership of the stock. The restriction on holding period on holding company stock in the Company's 401(k) and plans is currently being addressed at the Federal level. New legislation promulgating new rules is highly likely.

There are also substantial questions/concerns regarding the accounting practices and the lack of oversight exercised by both Enron's Audit Committee and Arthur Anderson, Enron's auditor. The independence of Audit Committees and outside auditing firms has been a corporate governance issue for several years. CalSTRS may wish to press the Securities and Exchange Commission (SEC) to address auditor independence standards. Arthur Anderson was paid over $25 million for consulting services in 2000; the appearance of conflict of interest or at least compromised independence seems evident. As a large institutional investor, CalSTRS may wish to encourage Congress and the SEC to strengthen the SEC's enforcement capability.

- ***WORK PLAN DISCUSSION***

The primary objective of the Corporate Governance Program is to fulfill the requirements of the Teachers' Retirement Law regarding this plan asset. The Teachers' Retirement Law states that CalSTRS is to "monitor each corporation any of whose shares are owned by the plan and to advise the board on the voting of the shares owned by the plan and on the responses of the system to merger proposals and tender offers and all other matters pertaining to corporate governance." This requirement was added to the law in 1984. The strategy is to monitor, analyze and execute votes on all of the companies in the CalSTRS equity portfolio.